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In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 804

JOHN G. MOFFATT, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court are reported at 42 T.C. 558. The opinion of the court of appeals is reported at 363 F. 2d 262. The order denying the taxpayers' petition for rehearing *en banc* is not officially reported.

JURISDICTION

The judgments of the court of appeals were entered on May 31, 1966, and rehearing was denied on August

29, 1966. The petition for a writ of certiorari was filed on November 28, 1966. The jurisdiction of this court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the transfer of all the operating assets of a corporation to a new corporation constituted a transfer of "substantially all of the assets of the transferor" within the meaning of § 354(b)(1)(A) of the Internal Revenue Code of 1954, so that the transaction was a corporate reorganization and the shareholders were taxable as a dividend on the non-operating assets distributed to them.

STATUTES INVOLVED

The pertinent provisions of the Internal Revenue Code of 1954 are set forth in the Appendix, *infra*, pp. 13-15.

STATEMENT

The facts are fully set forth in the Tax Court's opinion (R. 155-203);[1] in summary, they are as follows:

Moffatt & Nichol, Inc. ("M & N") was engaged in the business of consulting engineering in Long Beach, California. Its stock was owned by petitioners John G. Moffatt (45 percent), Frank E. Nichol (45 percent), and George G. Murray (10 percent).

[1] "R." references are to the printed record in the court of appeals.

Two of the three petitioners had sustained capital losses and wished to realize a capital gain against which to apply the losses. (Pet. App. 7, 10.)

In July, 1957, petitioners formed a new corporation, Moffatt & Nichol Engineers ("Engineers"). Petitioners borrowed $22,500 from M & N which they paid to Engineers for 90 percent of its capital stock. Ten percent of Engineers' stock was owned by a third party (an employee) for a short period of time; thereafter the stock ownership of Engineers was identical to that of M & N. In October, 1957, M & N's employees and business were transferred to Engineers. M & N loaned substantial sums of money to Engineers in return for the latter's notes. Thereafter M & N retained, in addition to the notes receivable from Engineers, certain accounts receivable, some cash, and a parcel of vacant land worth approximately $85,000 which was not related to its former engineering business (plus building plans relating to the land). (Pet. App. 10-12; R. 174-176.)

In December, 1958, M & N's board of directors voted to dissolve the corporation, and M & N distributed to petitioners (its stockholders) the following: $40,000 of promissory notes due from Engineers; $84,083 in cash; automobiles and other equipment worth $10,169; accounts receivable worth $20,303; and the vacant land (plus building plans) worth $85,000. Petitioners then transferred the cash, accounts receivable, and equipment to Engineers in return for additional notes receivable (Pet. App. 12; R. 176).

The Commissioner of Internal Revenue determined that the distributions from M & N to petitioners (less the amount paid to Engineers for stock purchased by them) were taxable as dividend distributions rather than as distributions in liquidation (R. 12, 28, 41, 57, 72, 85, 105). This determination was sustained by the Tax Court (Pet. App. 6), which was in turn affirmed by the court of appeals (Pet. App. 6-18). Both lower courts concluded that the series of steps here in question constituted a corporate reorganization within the terms of § 368(a)(1)(D) of the 1954 Code and that the property and notes received by petitioners constituted "boot," taxable as ordinary income under Code § 356(a)(2) (Pet. App. 15-18).

Petitioners now concede for purposes of this case that the transaction contained every element of a "D" reorganization except one, *i.e.*, they deny that "substantially all of the assets" of M & N were transferred to Engineers as required by Code § 354(b)(1) (Pet. 13-14). Thus, the sole question presented is whether substantially all M & N's assets were transferred to Engineers.

ARGUMENT

The decision below was correct, and there is no conflict of decisions or other reason for review by this Court.

1(a). In general, if substantially all the assets of a corporation (here M & N) are transferred to a new corporation (here Engineers) which is controlled by

the transferor corporation or its stockholders, the transaction constitutes a "D" reorganization. 1954 Code § 368(a)(1)(D), 354(b). If the transferor corporation (M & N) then liquidates and distributes retained assets (the vacant real estate) to its stockholders (petitioners) this property constitutes "boot" and is taxed as a dividend if it "has the effect of the distribution of a dividend." Code § 356(a)(2).

The theory behind this treatment is as follows: If M & N has distributed the vacant land while retaining its operating assets intact, the stockholders (petitioners) would have been taxed as a dividend on the value of the distributed property. If M & N transferred all of its operating assets to a new corporation (Engineers), which was essentially a continuation of M & N, and also distributed the vacant land to its stockholders, the distribution of the land should result in a dividend tax, just as if the transfer from one corporation to the other had not taken place.

The Code accomplishes this result by taxing as a dividend property ("boot") distributed to shareholders incident to a reorganization. Petitioners argue, however, that, even though M & N's business continued uninterrupted in the new corporate shell (Engineers), the instant transaction nevertheless does not constitute a reorganization and that they should be allowed to withdraw part of M & N's undistributed profits—in the form of the vacant land and notes—at the capital gains rate.[2] Petitioners contend that

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[2] If the transaction does not constitute a reorganization, 1954 Code § 331 dealing with complete liquidations would apparently make petitioners' profit on the transaction a capi-

because the nonoperating assets withdrawn from the corporation constituted 35 percent of the total assets (both operating and nonoperating), "substantially all of [M & N's] assets" were not transferred to Engineers as required by § 354(b)(1)(A).

(b) In a number of cases arising under the Internal Revenue Code of 1939, taxpayers had argued that similar transactions of this nature were not reorganizations with the attendant dividend tax on the "boot" distributed; rather, they argued that despite the continuation of the business by the new corporation, the transaction should be taxed as a complete liquidation with a resulting capital gain tax. The courts, however, have rejected these arguments and held that whenever the essential business enterprise is transferred to a new corporation which is controlled by the transferor corporation's stockholders, the transaction constitutes a "D" reorganization and the "boot" is taxable as a dividend. See, *e.g.*, *Liddon* v. *Commissioner*, 230 F. 2d 304 (C.A. 6), certiorari denied, 352 U.S. 824; *Pebble Springs Distill. Co.* v. *Commissioner*, 231 F. 2d 288 (C.A. 7), certiorari denied, 352 U.S. 836; *Lewis* v. *Commissioner*, 176 F. 2d 646 (C.A. 1); *Becher* v. *Commissioner*, 221 F. 2d 252 (C.A. 2).

(c) Although Congress revised some of the relevant reorganization sections when it enacted the 1954

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tal gain. If, on the other hand, the transaction is a reorganization, § 331 would be inapplicable and § 356(a) would tax the "boot" as a dividend if it "has the effect of the distribution of a dividend."

Code, we believe that the statutory language, the legislative history, and the pertinent policy considerations demonstrate that enactment of the 1954 Code did not change the rule that existed under the 1939 Code.

Before 1954 the "D" reorganization provision had included two discrete types of transactions: *First*, the divisive reorganization in which a single corporation is split into two separate corporations, and *second*, the reincorporation reorganization in which the operating assets of an existing corporation are transferred to a new corporation controlled by the same shareholders and the original corporation is liquidated.[3]

In enacting the 1954 Code Congress provided separate treatment for these two types of "D" reorganizations. Congress intended divisive "D" reorganizations to be controlled by § 355, while reincorporation "D" reorganizations would be covered by § 354(b)(1). The statutory mechanics for accomplishing this dichotomy were to make § 354(b)(1) applicable only if the original corporation had transferred "substantially all of [its] assets" to a single new corporation and liquidated; and to channel all other "D" reorganizations into § 355.

The legislative history demonstrates that these changes were designed to insure that no divisive reorganization could circumvent the strict new require-

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[3] A variation of this form is the unifying reorganization whereby the assets of two commonly controlled corporations are transferred to a single corporation.

ments of § 355, but were not intended to change the existing rules for reincorporation-type "D" reorganizations, such as the one here in question. The House bill had proposed a new statutory formula (proposed § 357) which was designed to provide stringent limitations on the use of reincorporation-type "D" reorganizations. See H. Rep. No. 1337, 83d Cong., 2d Sess., pp. A129-A134. The Senate rejected this proposed § 357 which would have changed the rules applicable to reincorporation reorganizations, and stated that its new § 354(b)(1) would impose "the same [rules] as under existing law." S. Rep. No. 1622, 83d Cong., 2d Sess., p. 265. The House receded from its position, expressing the view that "the possibility of tax avoidance in this area * * * can appropriately be disposed of by judicial decision or by regulation within the framework of the other provisions of the bill." H. Conf. Rep. No. 2543, 83d Cong., 2d Sess., p. 41.

(d). The effect of the instant transaction is that virtually all of M & N's operating assets were transferred to Engineers, and the vacant land which had never been used in M & N's business was distributed to the stockholders. Petitioners now concede that this would constitute a "D" reorganization and the distribution of the vacant land would constitute a dividend if substantially all of M & N's assets had been transferred to Engineers. However, petitioners argue that since the vacant land constituted 35 percent of M & N's total assets by value, less than substantially all of its assets were transferred to Engineers. If petitioners are correct, § 354(b)(1)(A) would con-

stitute a broad avenue of tax avoidance; any corporation which had a substantial amount of cash, liquid assets or investments could distribute them to its stockholders at the capital gain rate by merely coupling the distribution with a transfer of its operating assets to a newly-formed corporation and a liquidation of the old corporation. It is clear that Congress, in enacting the 1954 Code, did not intend to overrule the 1939 Code cases and create such a loophole. Thus, both lower courts properly employed a qualitative rather than a quantitative approach to the phrase "substantially all" and correctly concluded that when a corporation transfers all of its operating assets to a new corporation, and distributes nonoperating assets to stockholders, there has been a transfer to the new corporation of "substantially all of the assets" within the meaning of § 354(b)(1).[4]

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[4] In deciding that the words "substantially all of the assets" in § 354(b)(1)(A) did not require a mechanical percentage test, the court of appeals volunteered that it agreed with Rev. Rul. 57-518, 1957-2 Cum. Bull. 253, which said that the language "substantially all of the properties" in § 368(a)(1)(C) requires consideration of such elements as the nature of the property retained, the purpose of retention and the amount thereof (Pet. App. 15-16). And in a footnote the court of appeals sought to reconcile this position with *Pillar Rock Packing Co.* v. *Commissioner*, 90 F. 2d 949 (C.A. 9), where it had apparently taken a contrary view on the § 368(a)(1)(C) language (Pet. App. 16). Petitioners attack this attempted reconciliation (Pet. 16-19). However, we do not believe it necessary to consider the correctness of the Ninth Circuit's 30-year old opinion dealing with a "C" reorganization and the language of § 368(a)(1)(C) in the instant case dealing with a "D" reorganization and the language of § 354(b)(1)(A).

2. Both the Fifth and Tenth Circuits have recently indicated their agreement with a qualitative approach to 1954 Code § 354(b)(1)(A). See *Reef Corp.* v. *Commissioner*, 368 F. 2d 125, 131 (C.A. 5), affirming 24 TCM 379, 395, petition for certiorari pending No. 1005, this Term; *Babcock* v. *Phillips*, decided January 27, 1967 (C.A. 10); see also *Davant* v. *Commissioner*, 366 F. 2d 874, 884-887 (C.A. 5), petition for certiorari pending No. 911, this Term. These cases indicate that the "substantially all" requirement is met where virtually all of the operating assets are transferred to a new corporation, even though large amounts of liquid assets are distributed to stockholders. The Tenth Circuit emphasized that a reincorporation-type "D" reorganization is present when the new corporation is merely "a reincarnation" of the old, "the [old corporation's] business [is continued by the new] as a going concern," and the old corporation's stockholders are "not disassociated from the new corporation." *Babcock* v. *Phillips*, *supra*. The Fifth Circuit commented that "a study of the complete legislative history of section 368(a)(1)(D) clearly shows that when Congress added the second section in 1954, it was attempting to close old loopholes, not create new ones." *Davant* v. *Commissioner*, *supra*, p. 886, fn. 25. This flexible, qualitative approach to § 354(b)(1)(A)'s requirement of "substantially all" has been described in a leading text as "the sounder view that no particular percentage is controlling." Bittker and Eustice, *Federal Income*

Taxation of Corporations and Shareholders (1966 ed.), p. 526.[5]

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[5] Despite the absence of a conflict petitioners ask this Court to review this case in order to give the tax bar a broad definition of the terms used in § 354(b)(1)(A). However, this Court has expressly refused to lay down general rules with respect to the tax-free reorganization provisions, because of the danger that it would open them to tax avoidance schemes . See, *e.g.*, *Bazley* v. *Commissioner*, 331 U.S. 737, 741. Moreover, the Commissioner has sought to give some guidance as to the type of transactions to which he would grant favorable rulings. In Rev. Proc. 66-34, 1966-34 Int. Rev. Bull. 22, he states that although he is not attempting to define the statutory terms, he will "ordinarily" in granting advance rulings regard the "substantially all" requirement in § 354 (b)(1)(A) as satisfied if there is a transfer of 90 percent of the net assets or 70 percent of the gross assets held immediately prior to the transfer. Rev. Proc. 66-34 accomodates the need of the tax bar for some guide lines in the preparation of requests for rulings while also preserving the Commisioner's freedom of action in those cases where the percentage rules which "ordinarily" apply are not appropriate, *e.g.*, in situations like the instant case, where nonoperating assets have been held back for what is in substance a dividend distribution to shareholders.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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FEBRUARY 1967.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.

* * * *

(b) *Exception.*

(1) *In General.*—Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368(a)(1)(D), unless—

(A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and

(B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

* * * *

SEC. 356. RECEIPT OF ADDITIONAL CONSIDERATION.

(a) *Gain on Exchanges.*—

(1) *Recognition of Gain.*

If—

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) *Treatment as Dividend.* If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

* * * *

SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) *Reorganization.*

(1) *In General.* For purposes of parts I and II and this part, the term "reorganization" means—

* * * *

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but

only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

* * * *

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